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Ernest Gellhorn

Teresa Tatham

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## MAKING SENSE OUT OF THE RULE OF REASON

*Ernest Gellhorn\**

*Teresa Tatham\*\**

*Courts analyzing horizontal and vertical agreements between business entities once had a clear path to decision. If the agreement was of a certain kind, such as price-fixing, it was per se illegal and no justification could overcome that characterization. If the agreement was of another kind, such as information-sharing among members of a trade association, it was legal unless found to be unreasonable.*

*The authors argue that the previous clear division between the per se rule and the rule of reason has been blurred by recent Supreme Court decisions, and that many traditionally illegal restraints are now being subjected to the rule of reason analysis. The purpose of the Article is to provide guidance for those seeking to understand what factors will be taken into account by courts applying the developing rule of reason standard.*

### INTRODUCTION

HISTORICALLY, TWO standards have been applied to antitrust violations. The per se rule condemned certain activities automatically. Price-fixing, for example, was subjected to the per se rule. This standard traditionally has not allowed the defendant to justify the alleged violation; once a plaintiff establishes the violation, he will triumph. The rule of reason standard was reserved for instances in which the activity might be beneficial, such as certain agreements among members of a trade association. Under this standard, evidence of market conditions, justifications for the activity,

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\* Dean and Galen J. Roush Professor of Law, Case Western Reserve University School of Law. B.A., University of Minnesota (1956); LL.B., University of Minnesota School of Law (1962).

\*\* Student and an editor of the *Law Review*, Case Western Reserve University School of Law. A.B., Kenyon College (1980); J.D., Case Western Reserve University School of Law (1985).

and actual or potential effects on competition could be considered. In recent years, the distinction between these two standards has become blurred. The courts, following the lead of the Supreme Court, are analyzing traditional per se antitrust violations under the less strict rule of reason standard, or conducting a rule of reason type of analysis to determine whether the per se test should be applied. This trend makes it increasingly important to understand the rule of reason test.

The Supreme Court's initial opinions applying the rule of reason to alleged antitrust violations indicate that the economic effects of the activities are crucial to the analysis. However, the Court has failed to provide guidance on the specific factors to be considered. The rule of reason has not been authoritatively reviewed since the Supreme Court held in *Continental T.V., Inc. v. GTE Sylvania Inc.*<sup>1</sup> that nonprice vertical restraints were to be judged under the rule of reason. Lower courts have struggled with the language of *Sylvania* and its emphasis on the "pernicious effects" and the "redeeming virtues" of an activity. These courts have examined market shares, the effect on competition, and possible justifications for the restraints. It is to these opinions that one must turn to begin to understand the rule of reason standard. The lower court opinions, however, are not always clear and provide only a basis for continual development of the new standards. The Supreme Court and many lower courts often appear to be embracing a modern approach to antitrust economics, which provides an opportunity to clarify and rationalize this rule of reason.

## I. THE BREAKDOWN OF THE DISTINCTION BETWEEN THE PER SE RULE AND THE RULE OF REASON

Courts apply two standards to analyze collusive practices under antitrust statutes.<sup>2</sup> Horizontal price-fixing<sup>3</sup> and horizontal territorial allocations<sup>4</sup> are prototypical practices to which an automatic prohibition—the per se rule—is applied. Each involves an agreement among direct competitors where the effect on competition, in the form of reduced output and increased prices, creates an unjusti-

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1. 433 U.S. 36 (1977).

2. Sherman Antitrust Act, ch. 647, §§ 1-2, 26 Stat. 209 (1890) (current version at 15 U.S.C. §§ 1-2 (1982)).

3. See, e.g., *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940) (price-fixing among oil producers).

4. See, e.g., *United States v. Topco Assocs.*, 405 U.S. 596 (1972) (market division among retail grocers).

fied welfare loss. The per se rule makes these practices illegal without further consideration of their purpose, justification, or effect on the market. Vertical price-fixing, an agreement between suppliers and their customers to keep resale prices at a fixed level, also is subject to the per se rule, although the economic justifications for automatically prohibiting such arrangements are not well-grounded.<sup>5</sup>

The per se rule applies as well to exclusionary practices by individual firms which monopolize<sup>6</sup> or attempt to create monopolies.<sup>7</sup> The per se rule also is applied to joint actions such as vertical tie-in agreements where appreciable market power exists<sup>8</sup> and to some group boycotts.<sup>9</sup> The concern over these practices is that those seeking or sustaining a dominant position will limit entry or will make it unprofitable for others to compete by undercutting prices. As a result, these dominant firms will attain a larger share of the market and be able to set prices and production at noncompetitive levels. The justification for applying the per se rule to these exclusionary practices is the potential welfare loss, in the form of higher prices and reduced output, that monopolistic practices can impose on society.

Many horizontal agreements are encouraged or, at least, not evaluated so unfavorably. Horizontal arrangements such as a trade association's publication of market statistics from its members<sup>10</sup> or a cooperative program of institutional advertising by all or some firms in an industry<sup>11</sup> are not subject to the per se rule. Courts apply the more lenient rule of reason standard to such arrangements.<sup>12</sup> In applying this test, courts consider a number of factors: justifications for the practice, potential harm from the arrangement, market power of the participants, and the effect on competition.

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5. See Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1 (1977); Bork, *The Rule of Reason and the Per se Concept: Price-Fixing and Market Division* (pt. 2), 75 YALE L.J. 373 (1966).

6. See L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST §§ 33-39 (1977).

7. *Id.* §§ 49-52.

8. *Id.* §§ 150-156. See also *Jefferson Parish Hosp. v. Hyde*, 104 S. Ct. 1551, 1561-68 (1984) (discussion of the legality of tie-in arrangements).

9. L. SULLIVAN, *supra* note 6, at §§ 83-90. But see *Vogel v. American Soc'y Appraisers*, 744 F.2d 598, 600 (7th Cir. 1984) (boycotts are per se illegal only if used to enforce a practice that is itself illegal).

10. See, e.g., *Maple Flooring Mfrs. Ass'n v. United States*, 268 U.S. 563 (1925) (information-sharing among manufacturers).

11. See S. OPPENHEIMER, G. WESTON & J. MCCARTHY, *FEDERAL ANTITRUST LAWS* 102 (4th ed. 1981).

12. But see Gerhart, *The Supreme Court and Antitrust Analysis: The (Near) Triumph of the Chicago School*, 1982 SUP. CT. REV. 319.

The courts generally allow the arrangement if potential benefits to competition outweigh immediate or potential harm.

### A. *Consumer Welfare Approach*

The previous bright line between per se illegality and rule of reason legality has begun to break down in recent years as the courts, particularly the Supreme Court, have developed a more sophisticated understanding of antitrust economics. The reasons for this breakdown are numerous. First, it is thought to be economically beneficial to encourage all firms—even those with market power—to expand output and to sell their goods and services at competitive prices. Therefore, courts generally adopt the rule of reason approach if the challenged action can be characterized as ancillary to “legitimate business practices.”<sup>13</sup>

Another factor is that courts have come to recognize important distinctions between horizontal and vertical collusion. In the past, courts sometimes borrowed antitrust concepts developed for horizontal arrangements—involving direct competitors—and applied them to vertical practices—involving suppliers and their customers—without considering inherent analytical differences and basic economic distinctions. For example, the per se rule of *Dr. Miles Medical Co. v. John D. Park & Sons Co.*<sup>14</sup> is applied to prohibit all resale price maintenance even though vertical price-fixing has long been shown to serve ends very different from horizontal price-fixing.<sup>15</sup> However, when the challenged practice appears to be clearly desirable, courts sometimes employ artful distinctions to avoid automatic prohibitions. Finally, there is increasing recognition that the most appropriate goal for the antitrust laws is to promote “consumer welfare” by fostering economic efficiency rather than by protecting smaller firms from the pressures of competition. This recognition reflects growing economic sophistication on the part of

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13. See *United States v. Addyston Pipe & Steel Co.*, 85 F. 271 (6th Cir. 1898) (Taft, J.), modified and *aff'd*, 175 U.S. 211 (1899); R. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 26-30, 263-79 (1978). See also *NCAA v. Board of Regents of the Univ. of Okla.*, 104 S. Ct. 2948 (1984) (although a certain amount of cooperation is needed to maintain competition in college athletics, an agreement restricting television rights inhibited competition and, therefore, failed a rule of reason analysis); *Broadcast Music, Inc. v. CBS*, 441 U.S. 1 (1979) (agreement among composers to sell their compositions for a fixed price passes rule of reason analysis because restraint is necessary to encourage production).

14. 220 U.S. 373 (1911).

15. See, e.g., Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960); Bork, *supra* note 5; cf. Brief of the Department of Justice, as Amicus Curiae in Support of Petitioner, *Spray-Rite Serv. Corp. v. Monsanto Co.*, 684 F.2d 1226 (7th Cir. 1982), *aff'd on other grounds*, 104 S. Ct. 1464 (1984).

the judiciary, as well as greater political acceptance of the need to foster economic growth. A number of recent cases illustrate the trend away from application of the per se rule.

In *Broadcast Music, Inc. v. CBS*,<sup>16</sup> the Supreme Court remanded, for a rule of reason analysis, an agreement among a group of composers to issue a blanket license to CBS to perform the composers' songs at set fees. The Court concluded that a pricing arrangement which is essential to a legitimate purpose is not within the per se rule otherwise applied to horizontal price-fixing unless it is "plainly anticompetitive" and very likely without 'redeeming virtue.'"<sup>17</sup> The Court said the arrangement was essential to the production of the compositions and, therefore, served a legitimate purpose in the marketplace. Further, the Court specified that in deciding whether to apply the per se or rule of reason standard, the lower court should analyze whether the practices "facially . . . tend to restrict competition and decrease output . . . or instead are designed to 'increase economic efficiency and render markets more, rather than less, competitive.'"<sup>18</sup>

The 1983 Supreme Court Term produced three cases which further exemplify the Court's tendency to avoid rigid application of the per se rule. In *NCAA v. Board of Regents of the University of Oklahoma*,<sup>19</sup> the Court refused to apply the per se rule to allegations that the NCAA had fixed prices for telecasts of college football games and that the exclusive network contracts were tantamount to a group boycott of all other broadcasters.<sup>20</sup> The Court stated that although the use of exclusive contracts to limit the number of televised games constituted horizontal price-fixing and limits on output, it would be inappropriate to apply the per se rule to "an industry in which horizontal restraints on competition are essential if the product is to be available at all."<sup>21</sup> Nonetheless, the Court, after a rule of reason analysis, concluded that the arrangements were an unreasonable restraint on competition.<sup>22</sup>

In *Jefferson Parish Hospital v. Hyde*,<sup>23</sup> the Court in effect applied a rule of reason analysis to a tying arrangement involving an

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16. 441 U.S. 1 (1979).

17. *Id.* at 9.

18. *Id.* at 19-20 (quoting *United States v. United States Gypsum Co.*, 438 U.S. 422, 441 n.16 (1978)).

19. 104 S. Ct. 2948 (1984).

20. *Id.* at 2960.

21. *Id.* at 2961.

22. *Id.* at 2962-67.

23. 104 S. Ct. 1551 (1984).

exclusive hospital contract with a firm of anesthesiologists.<sup>24</sup> The Court stated that tying arrangements have been condemned only "when the seller has some special ability—usually called 'market power'—to force a purchaser to do something that he would not do in a competitive market."<sup>25</sup> This statement limits the per se rule to a narrow field. The Court found that the hospital's thirty percent market share was not enough market power to prevent a patient from entering a competing hospital and using the services of other anesthesiologists.<sup>26</sup> Applying a rule of reason analysis, the Court found that there was insufficient evidence to show that the arrangement unreasonably restrained competition.<sup>27</sup>

*Monsanto Co. v. Spray-Rite Service Corp.*<sup>28</sup> further illustrates the Court's unwillingness to apply a per se rule rigidly. Spray-Rite, a cut-rate distributor of herbicides, claimed that Monsanto, directly and through customer and territorial restraints, conspired to fix the resale price of its herbicides.<sup>29</sup> The district court instructed the jury that if it found that the nonprice restrictions were part of an unlawful scheme to fix prices, Monsanto's actions were subject to the per se rule against price-fixing.<sup>30</sup> Its ruling was affirmed by the Seventh Circuit.<sup>31</sup> More importantly, the appellate court held that "proof of termination following competitor complaints is sufficient to support an inference of concerted action."<sup>32</sup> The implications of such a low standard for inferring collusion are obvious. A manufacturer who independently terminates a dealer for failure to comply with legitimate vertical restraints and who also has received price complaints about that dealer will find it almost impossible to refute the inference of concerted action. The result will be application of the per se rule and probable treble damages. In light of this standard, it was not surprising that the court upheld the jury finding for Spray-Rite.

The Supreme Court rejected the minimal standard of proof required by the Seventh Circuit to establish a conspiracy.<sup>33</sup> The Court emphasized the basic distinction between independent and

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24. *Id.*

25. *Id.* at 1559.

26. *Id.* at 1566.

27. *Id.* at 1567-68.

28. 104 S. Ct. 1464 (1984).

29. *Id.* at 1467.

30. *Id.*

31. *Id.* at 1468.

32. *Monsanto Co. v. Spray-Rite Serv. Corp.*, 684 F.2d 1226, 1238 (7th Cir. 1982), *aff'd on other grounds*, 104 S. Ct. 1464 (1984).

33. 104 S. Ct. at 1468. There had been a longstanding conflict between the circuits as to the proper standard of proof for establishing the existence of concerted action. See *id.* at n.5.

concerted action and reminded lower courts that a manufacturer has a right to deal, or refuse to deal, with whomever he wishes as long as that right is exercised independently.<sup>34</sup> The Court noted that as a natural course of doing business, manufacturers and distributors are in constant communication about prices and marketing strategies.<sup>35</sup> This is especially true when a manufacturer implements nonprice restrictions as a marketing strategy. Distributors who comply with such costly programs will necessarily voice complaints to manufacturers about cut-rate distributors who benefit from their efforts.<sup>36</sup> The Court concluded that there must be evidence that tends to exclude the possibility of independent action by the manufacturer and distributor.<sup>37</sup> That is, there must be "direct or circumstantial evidence that reasonably tends to prove that the manufacturer and others had a conscious commitment to a common scheme designed to achieve an unlawful objective"<sup>38</sup> before the per se rule will apply.

The Court appeared to require substantial proof, although it found on the basis of ambiguous evidence<sup>39</sup> that Monsanto and its distributors were parties to a conspiracy to fix prices. Nonetheless, the Court's decision illustrates its general willingness to embrace an economic approach based on whether a particular business practice is efficient rather than to adhere blindly to past practices of protecting small businesses regardless of the harm to consumer welfare.

The "consumer welfare" approach used by the Supreme Court in *Broadcast Music*, *NCAA*, *Hyde*, and *Monsanto* is not novel. In *Continental T.V., Inc. v. GTE Sylvania Inc.*,<sup>40</sup> the Court expressly ruled that nonprice vertical restraints, in particular territorial and customer marketing restrictions imposed on distributors, should be evaluated under the rule of reason.<sup>41</sup> In reaching that conclusion,

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34. *Id.* at 1469.

35. *Id.* at 1470.

36. *Id.*

37. *Id.* at 1471.

38. *Id.*

39. The Court cited two pieces of evidence in support of its decision against Monsanto. First was testimony that in the months following Spray-Rite's termination other price-cutters were advised that if they did not maintain prices they would be terminated. *Id.* Second, a newsletter, dated four weeks before Spray-Rite's termination, discussed Monsanto's incentive and shipping programs and stated that "every effort will be made to maintain a minimum market price level." *Id.* This evidence of an alleged agreement to fix prices was linked to Spray-Rite's termination through testimony from Spray-Rite's president that a Monsanto official mentioned price complaints in a meeting following Spray-Rite's termination. *Id.* at 1472.

40. 433 U.S. 36 (1977).

41. *Id.* at 49-59.



the Court suggested several justifications for nonprice vertical restraints such as expanded product distribution, increased dealer investment, and improved customer service as well as the elimination of "free-riders."<sup>42</sup> The Court also emphasized that an important consideration should be the effect of the restriction on economic efficiency and interbrand competition.<sup>43</sup>

These cases suggest that an examination of market conditions and economic effects is necessary to determine whether the per se rule applies in horizontal cases or whether the rule of reason standard has been satisfied in vertical cases. However, the Supreme Court's message has been far from clear. Although *Broadcast Music*, *NCAA*, *Hyde*, and *Monsanto* illustrate a gradual acceptance of a "consumer welfare" approach to antitrust, the Court's most recent opinions also reflect its reluctance to depart completely from past precedent protecting smaller businesses regardless of efficiency considerations.<sup>44</sup> In fact, the Court ignored the primary thrust of its decision in *Broadcast Music* when it applied the per se rule in *Arizona v. Maricopa County Medical Society*.<sup>45</sup>

### B. Remnants of the "Civil Rights" Approach

In *Maricopa*, the Court was faced with a system for delivering health care services based upon the establishment of maximum fees. The Court disregarded the significant cost savings to consumers and mechanically applied a per se rule. The majority's conclusory analysis simply announced that "the anticompetitive potential inherent in all price-fixing agreements justifies their facial invalidation even if procompetitive justifications are offered."<sup>46</sup> In an unsatisfactory attempt to distinguish *Broadcast Music*, the majority termed the arrangement in *Maricopa* "fundamentally different."<sup>47</sup> A sharp dissent pointed out that it is "well settled that this [per se] characterization is not to be applied as a talisman to every arrangement that involves a literal fixing of prices."<sup>48</sup>

Even the post-*Maricopa* opinions in *Hyde*, *NCAA*, and *Monsanto* reflect the Court's reluctance to embrace fully a careful eco-

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42. *Id.* at 54-55.

43. *Id.*

44. See *NCAA v. Board of Regents of the Univ. of Okla.*, 104 S. Ct. 2948 (1984); *National Soc'y of Professional Eng'rs v. United States*, 435 U.S. 679, 692 (1978).

45. 457 U.S. 332 (1982).

46. *Id.* at 351.

47. *Id.* at 356.

48. *Id.* at 361-62.

nomic approach to antitrust analysis.<sup>49</sup> The decision in *NCAA* may cause the most difficulty. The Court did consider various economic factors in its refusal to apply the per se rule to the "naked"<sup>50</sup> horizontal restrictions imposed by the NCAA on the televising of football games. Nonetheless, major portions of the Court's language are troublesome. For example, the Court stated that "the absence of proof of market power does not justify a naked restriction on price or output."<sup>51</sup> This statement illustrates that the Court is not appropriately considering the basic economic fact that without market power there can be no adverse impact on prices and output.

*Hyde* and *Monsanto* also illustrate the Court's failure to provide a clear economic analysis of the challenged restraint. Although the Court in *Hyde* in effect applied a rule of reason analysis to a tying arrangement, it did not formally abandon application of the per se rule to all such arrangements. Instead of reexamining the economic validity of applying the per se rule to tying arrangements in general—which four members of the Court favored—the Court limited the application of the rule to a narrow field.<sup>52</sup> *Monsanto* presented another opportunity for the Court to review, in modern economic terms, the validity of per se illegality of vertical price restraints. The Court refused to reexamine its decision in *Dr. Miles* although the same arguments that persuaded the Court in *Sylvania* to apply a rule of reason to nonprice vertical restraints support the abandonment of the per se rule in resale price maintenance cases.<sup>53</sup> The Court did make it more difficult for a plaintiff in a dealer termination case to invoke the per se rule.<sup>54</sup> However, because of the obvious weakness and self-serving nature of the evidence,<sup>55</sup> it is unclear whether *Monsanto's* stated higher standard of proof will, in fact, provide much protection for manufacturers faced with allegations of a conspiracy to fix prices.<sup>56</sup> The Court's strained effort to find

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49. See Sims and Myers, *Baxter Grabs Brass Ring in 1984 Antitrust Season*, Legal Times, July 23, 1984, at 10, col. 1 for an early and thoughtful discussion of the 1984 Supreme Court antitrust decisions. The authors compare the "civil rights" approach of the Warren Court with the movement toward a more modern economic approach of the current Court.

50. 104 S. Ct. at 2965.

51. *Id.*

52. 104 S. Ct. at 1570.

53. See *supra* note 5.

54. 104 S. Ct. at 1473.

55. See *supra* note 39.

56. Whether the lower courts will follow what the Supreme Court "said" in *Monsanto* rather than what it "did" remains to be seen. See, e.g., *Malley-Duff & Assocs. v. Crown Life Ins. Co.*, 734 F.2d 133 (3d Cir. 1984) (noting the Supreme Court's emphasis on distinguishing concerted and unilateral action, the court found both direct and circumstantial evidence that

evidence of concerted action and, therefore, find for the small businessman, Spray-Rite, as well as its refusal to address the validity of its 1911 decision equating vertical and horizontal price-fixing, is illustrative of its reluctance to part with the past.

The Supreme Court has clearly moved toward acceptance of a "consumer welfare" approach to antitrust but its inability to break with the past has led to much confusion over the proper approach for determining whether the per se rule is to be applied. *Broadcast Music*, *Hyde*, *NCAA*, and *Monsanto* illustrate the economic considerations on which the Court is beginning to focus before applying the per se rule. This economic analysis is much like the analysis courts apply to nonprice vertical restraints under a rule of reason.

The development of the rule of reason standard has been more abrupt and sometimes more coherent in nonprice vertical restraint cases. The explicitness of *Sylvania* and its widespread acceptance in the antitrust community has meant that direct challenges to non-price vertical arrangements are generally treated as rule of reason cases. *Sylvania* forces an examination of the economic effects and justifications for nonprice vertical restraints. Although considerable lower court confusion still exists over the meaning of the rule of reason standard applied in *Sylvania*, these lower court decisions provide the only guidance on the meaning of the rule of reason.

## II. UNDERSTANDING THE SYLVANIA RULE

A brief review of the law regarding restrictions on the distribution of goods and services is necessary to understand the rule of reason standard. The standard as applied to vertical restraints grew out of a three-quarter-century dispute concerning the right of a manufacturer to control the distribution and price of his products and services.

### A. Doctrinal Gyration: From Dr. Miles to Sylvania

The earliest and leading case applying antitrust standards to vertical restraints was a tort action against a drug manufacturer for restricting the resale price of his products through contracts with wholesalers. In *Dr. Miles*,<sup>57</sup> the Supreme Court, relying on com-

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a life insurance agency was terminated pursuant to a group boycott between the insurance carrier and others); *St. Petersburg Yacht Charters, Inc. v. Morgan Yacht, Inc.*, No. 82-2704 (Fla. Dist. Ct. App. May 4, 1984) (termination of a dealership after a rival dealer requested such termination to eliminate resale price competition was not per se illegal).

57. 220 U.S. 373 (1911).

mon law rules prohibiting restraints on the alienation of property, held that a manufacturer who sells his product to a wholesaler is not entitled to restrict its subsequent resale by a retailer. Although not labeled as such, the ruling that resale price maintenance (RPM) is injurious to the public interest and void<sup>58</sup> was in effect a holding that vertical price restraints were per se illegal. *Dr. Miles* was a vertical price-fixing case, but the Court's theory and doctrine were not necessarily limited to price agreements.

For many years the central issue was whether a manufacturer could avoid the rule in *Dr. Miles* by refusing to sell to retailers who failed to comply with his suggested price or by consigning rather than selling the product to a distributor. In 1919, the Supreme Court created the *Colgate* exception to the per se rule of *Dr. Miles* by permitting a manufacturer to recommend prices unilaterally and cut off retailers who failed to comply. In *United States v. Colgate*,<sup>59</sup> the Court observed that a manufacturer is necessarily entitled to set the price at which his product is sold and to determine with whom he will deal. This exception proved to be of limited use because a manufacturer's only option to enforce the resale price was to drop the best known price-cutter with no warning and hope that the action served as an example to other price-cutters. Subsequent Supreme Court decisions, especially *United States v. Parke, Davis & Co.*,<sup>60</sup> further reduced the usefulness of *Colgate* by holding that any method of securing compliance with a suggested retail price constituted an "agreement" for purposes of section 1 of the Sherman Act.<sup>61</sup>

The Court, in *United States v. General Electric Co.*,<sup>62</sup> approved a resale price maintenance arrangement in which a dealer was a consignee of the manufacturer and, therefore, acted as his agent. The Supreme Court cast doubt on this exception when it invalidated a virtually identical "consignment" arrangement in *Simpson v. Union Oil Co.*<sup>63</sup> The limitations of *Parke, Davis* and *Simpson* made it difficult for a manufacturer to control the retail price of his product unless he established his own distribution system and did not deal with others.

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58. *Id.* at 404.

59. 250 U.S. 300 (1919).

60. 362 U.S. 29 (1960).

61. Sherman Antitrust Act, ch. 347, § 1, 26 Stat. 209 (1890) (current version at 15 U.S.C. § 1 (1982)).

62. 272 U.S. 476 (1926).

63. 377 U.S. 13 (1964).

The 1975 repeal<sup>64</sup> of the Miller-Tydings Act further restricted a manufacturer's ability to impose vertical price restraints. In the 1930's, individual states began to pass "fair trade" laws which specifically authorized manufacturers to set the resale prices of their products. Congress approved the Miller-Tydings Act<sup>65</sup> in 1937 to validate resale price maintenance arrangements which involved interstate commerce and which were permitted under the antitrust laws of a particular state. Judicial limitations on *Colgate* and *General Electric* and the repeal of the Miller-Tydings Act essentially foreclosed the opportunity for vertical price restrictions. Manufacturers then focused their attention on nonprice restraints such as territorial and customer limitations. Until the 1940's, the government did not challenge these arrangements and, in fact, such restraints were approved in several private actions.<sup>66</sup>

In 1944, the Supreme Court, in *United States v. Bausch & Lomb Optical Co.*,<sup>67</sup> held vertical territorial and customer restrictions to be per se illegal if they were an integral part of an agreement to fix prices. Four years later, the Department of Justice, relying on *Bausch & Lomb*, announced that it would treat vertical territorial and customer restraints unaccompanied by price-fixing on the same basis. For many years this position went unchallenged. Consent agreements negotiated by the Department enforced the view that all vertical restraints, whether price or nonprice, were automatically illegal.<sup>68</sup>

When the Supreme Court heard its first nonprice vertical restraint case, however, it reversed a lower court's holding that territorial and customer restrictions were illegal per se. In *White Motor Co. v. United States*,<sup>69</sup> the Court concluded that it did not "know enough of the economic and business stuff out of which these ar-

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64. Consumer Goods Pricing Act, Pub. L. No. 94-145, 89 Stat. 801 (1975).

65. District of Columbia Revenue Act of 1937, ch. 690, tit. VIII, 50 Stat. 693 (repealed 1975).

66. See ABA ANTITRUST SECTION, MONOGRAPH NO. 2, VERTICAL RESTRICTIONS LIMITING INTRABRAND COMPETITION 7 n.14 (1977) for a listing of these private actions which include: *Chicago Sugar Co. v. American Sugar Ref. Co.*, 176 F.2d 1 (7th Cir. 1949), cert. denied, 338 U.S. 948 (1950); *Fosburgh v. California & Hawaiian Sugar Ref. Co.*, 291 F.2d 29 (9th Cir. 1923); *Coca-Cola Bottling Co. v. Coca-Cola Co.*, 269 F. 796 (D. Del. 1920).

67. 321 U.S. 707 (1944).

68. See ABA ANTITRUST SECTION, *supra* note 66, at 7-8 n.17 (1977) for a listing of these consent decrees which include: *United States v. Lone Star Cadillac Co.*, 1963 Trade Cas. (CCH) ¶ 70,739 (N.D. Tex. 1963); *United States v. Sperry Rand Corp.*, 1962 Trade Cas. (CCH) ¶ 70,495 (W.D.N.Y. 1962); *United States v. Shaw-Walker Co.*, 1962 Trade Cas. (CCH) ¶ 70,491 (W.D.N.Y. 1962).

69. 372 U.S. 253 (1963).

rangements emerge”<sup>70</sup> to be certain whether they stifle or invigorate competition. Therefore, it remanded the case for a trial on the merits.<sup>71</sup> In light of the three dissenters’ argument for a per se rule, the opinion was widely interpreted as applying a rule of reason approach to nonprice vertical restraints.<sup>72</sup> In fact, the Court merely ruled “that the legality of territorial and customer limitations should be determined only after a trial.”<sup>73</sup> The case was settled on remand and, therefore, the Court did not have an opportunity to determine whether the per se rule or rule of reason applied to non-price vertical restraints.

Nevertheless, it seemed that the rule of reason was the appropriate standard as two appeals courts almost immediately overturned more stringent Federal Trade Commission decisions.<sup>74</sup> Neither court, nor for that matter, the Supreme Court in *White Motor*, heeded the argument that nonprice dealer restrictions violated property law rights of resale. Thus, it came as a surprise when the Supreme Court returned to the rationale of *Dr. Miles* and held in *United States v. Arnold, Schwinn & Co.*,<sup>75</sup> that “[o]nce the manufacturer has parted with title and risk . . . his effort thereafter to restrict territory or persons to whom the product may be transferred . . . is a per se violation of § 1 of the Sherman Act.”<sup>76</sup>

The sweeping nature of the *Schwinn* rule was immediately and harshly criticized.<sup>77</sup> Lower courts applied the decision narrowly and developed numerous exceptions.<sup>78</sup> Partly in response to *Schwinn*, a new economic view of vertical restrictions became

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70. *Id.* at 263.

71. *Id.* at 264.

72. This interpretation, which is erroneous, is still repeated. See, e.g., Halverson, *An Overview of Legal and Economic Issues and the Relevance of the Vertical Merger Guidelines*, 52 ANTITRUST L.J. 49, 55 (1983).

73. 372 U.S. at 264.

74. See *Sandura Co. v. FTC*, 339 F.2d 847 (6th Cir. 1964) (dealer restrictions were reasonable business practices); *Snap-On Tools Corp. v. FTC*, 321 F.2d 825 (7th Cir. 1963) (territorial restrictions are permissible vertical restraints under a rule of reason standard).

75. 388 U.S. 365 (1967).

76. *Id.* at 382.

77. See, e.g., Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 COLUM. L. REV. 282, 295-97 (1975); Robinson, *Recent Antitrust Developments*, 75 COLUM. L. REV. 243, 270-72 (1975); Handler, *The Twentieth Annual Antitrust Review*, 53 VA. L. REV. 1667, 1680-86 (1967).

78. See ABA ANTITRUST SECTION, *supra* note 66, at 13-14 nn.34 & 38 for a listing which includes: *Colorado Pump & Supply Co. v. Febco, Inc.*, 472 F.2d 637, 639 (10th Cir.), *cert. denied*, 411 U.S. 987 (1973); *Carter-Wallace, Inc. v. United States*, 449 F.2d 1374, 1378-82 (Ct. Cl. 1971).

widely accepted. That view was that vertical restrictions serve many useful ends: more efficient distribution, protection against free-riders, and lower costs.<sup>79</sup> Commentators advancing this economic approach also demonstrated that the adverse effects of vertical restraints are more theoretical than real, and in fact are implausible given our economic structure.

The process of evaluation and change was not gradual. Shortly after the tenth anniversary of the *Schwinn* decision, the next territorial restriction case reached the Supreme Court, and the law changed abruptly. In *Continental T.V., Inc. v. GTE Sylvania Inc.*,<sup>80</sup> the Court expressly overturned *Schwinn* and announced that a rule of reason test should be applied to nonprice restrictions imposed by manufacturers on their dealers. The Court recognized that distribution restrictions could achieve efficiencies by promoting retailer and distributor investments in promotional activities and quality controls.<sup>81</sup>

### B. *The Sylvania Opinion*

In overruling the per se rule of *Schwinn*, Justice Powell quoted at length from Justice Brandeis' elliptical statement of the rule of reason in *Chicago Board of Trade v. United States*,<sup>82</sup> but provided no further elaboration.

The Brandeis formulation of the rule of reason provides that:

[T]he legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of intent may help the court to interpret facts and to predict

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79. See generally Posner, *The Chicago School of Antitrust*, 127 U. PA. L. REV. 925 (1975); R. BORK, *supra* note 13; Posner, *supra* note 5; Bork, *supra* note 5.

80. 433 U.S. 36 (1977).

81. *Id.* at 55.

82. 246 U.S. 231 (1918).

consequences.<sup>83</sup>

The elements noted by Justice Brandeis—circumstances peculiar to the business, conditions before and after the restraint, the nature and purpose of the restraint—are necessary to the rule of reason analysis. But as such disparate commentators as Dean Robert Pitofsky<sup>84</sup> and Judge Richard Posner<sup>85</sup> have noted, the mere listing of areas for inquiry provides virtually no guidance on the meaning of the rule or how it should be applied.

In *Sylvania* the Supreme Court held that nonprice vertical restrictions should not be automatically condemned. The Court noted that such restrictions could be used by manufacturers to penetrate new markets, to protect full-priced dealers from free-riders who otherwise would destroy any incentives for dealer investment in promotion and services, and to assure product quality and customer safety.<sup>86</sup> The Court acknowledged that, depending on the scope of the restrictions, competition among dealers of the same product (intrabrand competition) would be stifled.<sup>87</sup> This, however, could be outweighed by benefits to competition among manufacturers (interbrand competition).<sup>88</sup>

The Court in *Sylvania* stated that some nonprice vertical restraints could still be per se illegal,<sup>89</sup> but failed to provide any guidance as to which ones. In a footnote, it reiterated that resale price agreements remained void under the rule of *Dr. Miles*.<sup>90</sup>

Thus, the opinion in *Sylvania* provided little guidance for analyzing a manufacturer's nonprice vertical restrictions. It is not clear, for example, whether the market power of the manufacturer is important. Nor did the Court indicate whether intrabrand costs are simply to be weighed against interbrand benefits, with the restraint upheld unless the costs outweigh the benefits. Is it important that the likely adverse effects of any restriction on interbrand competition are minimal or nonexistent even though intrabrand competition is eliminated? Is a manufacturer to be punished with treble damages and attorneys' fees if purported efficiencies are, in fact, not

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83. *Id.* at 238.

84. Pitofsky, *The Sylvania Case: Antitrust Analysis of Non-Price Vertical Restrictions*, 78 COLUM. L. REV. 1, 11 (1978).

85. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 14-15 (1981).

86. 433 U.S. at 55.

87. *Id.* at 54.

88. *Id.*

89. *Id.* at 58.

90. *Id.* at 51 n.18.



realized, and the market has already exacted a toll for this mistake? The Court also failed to acknowledge that applying the rule of reason has generally meant that the defendant is exonerated.<sup>91</sup>

Lower courts have faced a steady diet of cases raising the question of the appropriate standard of proof in a nonprice vertical restriction case under a rule of reason.

### III. APPLYING THE RULE OF REASON IN THE COURTS<sup>92</sup>

In *Sylvania* Justice Powell suggested two criteria for determining whether the rule of reason standard is met. The initial consideration is whether the arrangement is likely to have a "pernicious effect" on interbrand competition.<sup>93</sup> The second consideration is whether the restraint has "redeeming virtues."<sup>94</sup> These related concepts have become departure points for a rule of reason analysis.

#### A. The "Pernicious Effect" Requirement

Vertical restraints that do not directly affect price were subjected to the rule of reason analysis by the Supreme Court in *Sylvania* because they may promote rivalry among competitors (interbrand competition).<sup>95</sup> *Sylvania* adopted a distribution scheme in the early 1960's to control dealer territories through location clauses.<sup>96</sup> These restrictions were imposed when *Sylvania* had one or two percent of the U.S. market.<sup>97</sup> At that time, the market leader (RCA) had a sixty to seventy percent share of the television set market.<sup>98</sup> Even attributing all of *Sylvania*'s subsequent success to its location clauses, *Sylvania* still had but five percent of the market when sued several years later by a dealer.<sup>99</sup> Given the numer-

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91. This was, at least, the result until 1977. See Posner, *supra* note 5, at 14. But see *NCAA v. Board of Regents of the Univ. of Okla.*, 104 S. Ct. 2948 (1984) (an agreement limiting television rights restrained price and output and restricted competition and, therefore, failed a rule of reason analysis); *National Soc'y of Professional Eng'rs v. United States*, 435 U.S. 679 (1978) (rule of reason held insufficient to exonerate defendant under a defense based upon the assumption that competition itself is unreasonable within engineering profession).

92. This section of the Article borrows heavily from the two excellent discussions of nonprice restrictions: Rill, *Non-Price Vertical Restraints Since Sylvania: Market Conditions and Dual Distribution*, 52 ANTITRUST L.J. 95 (1983); W. LIEBLER, ANTITRUST ADVISER §§ 2.20-21 (2d ed. 1983 Cum. Supp.). Our analysis, however, differs somewhat from theirs.

93. 433 U.S. at 58-59.

94. *Id.*

95. *Id.* at 51-52.

96. *Id.* at 38.

97. *Id.*

98. *Id.* at n.1.

99. *Id.* at 38-40.

ous alternatives available to retail consumers, Sylvania did not have the market power to affect the retail price of television sets. In economic terms, Sylvania's restriction on intrabrand competition could have no adverse effect on interbrand competition or consumer welfare.

The Court's opinion in *Sylvania* clearly indicates that a mere showing of an intrabrand impact is not enough to find a pernicious effect on competition. An adverse intrabrand impact is a necessary result of every successful vertical restraint. Unless the restraint reduces competition among producers of competing products (interbrand effects), the restraint cannot adversely affect competition. Therefore, the "pernicious effect" on competition can be demonstrated only by evidence that the vertical restriction has an adverse interbrand effect, that is, it reduces output and raises the price of the product significantly above the competitive level in the industry as a whole.

The burden of proving that a manufacturer's restrictions on intrabrand competition have had a "pernicious effect" on interbrand competition will most often lie with the plaintiff in a vertical restraint case. In *Daniels v. All Steel Equipment, Inc.*,<sup>100</sup> the Fifth Circuit required the plaintiff, an office furniture dealer whose dealership was involuntarily terminated, to prove that his termination adversely affected interbrand competition.<sup>101</sup> The court affirmed the grant of summary judgment for the defendant because the plaintiff failed to present any evidence of an anticompetitive effect involving more than the manufacturer's product.<sup>102</sup>

The Second Circuit, in *Oreck Corp. v. Whirlpool Corp.*,<sup>103</sup> used an analysis similar to that of the Fifth Circuit in *Daniels* and required that the plaintiff present evidence of an adverse effect on interbrand competition. The plaintiff, a distributor of Whirlpool vacuum cleaners, alleged that his dealership was terminated in an

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100. 590 F.2d 111 (5th Cir. 1979). See also *Carlson Machine Tools, Inc. v. American Tool, Inc.*, 678 F.2d 1253 (5th Cir. 1982) (plaintiff's evidence is insufficient to establish coercive enforcement of suggested prices); *Kestenbaum v. Falstaff Brewing Corp.*, 575 F.2d 564 (5th Cir. 1978) (plaintiff's evidence held insufficient to support its claim that the brewer's activities had any anticompetitive effect), *cert. denied*, 440 U.S. 909 (1979). But see *Mendelovitz v. Adolph Coors Co.*, 693 F.2d 570, 575 (5th Cir. 1982) (per se rule applicable if behavior is determined to have such a pernicious effect on competition that it is conclusively presumed to be an unreasonable restraint of trade).

101. 590 F.2d at 113.

102. *Id.* at 113-14.

103. 579 F.2d 126 (2d Cir.), *cert. denied*, 439 U.S. 946 (1978). See also *Borger v. Yamaha Int'l Corp.*, 625 F.2d 390 (2d Cir. 1980) (en banc) (the legality of an agreement depended upon the effect of a restraint on interbrand competition).

effort by Whirlpool and another distributor to end all price competition in Whirlpool vacuum cleaner sales.<sup>104</sup> Finding for the defendant, the court noted that something more than an agreement between Whirlpool and the other distributor must be proven.<sup>105</sup> The court required that the plaintiff show "that from this course of conduct there was an anticompetitive effect on the vacuum cleaner industry as a whole."<sup>106</sup> Relying on *Colgate*, the court stated that it is a manufacturer's prerogative to decide with whom he will deal and that a mere refusal to deal should not be a basis for antitrust liability.<sup>107</sup>

In determining whether a nonprice vertical restraint actually has a "pernicious effect" on competition, several courts have focused on the likely interbrand effect of the restriction by examining whether the manufacturer, in fact, had any power over the market. Two questions are often addressed to determine a defendant's market power: (1) whether the defendant has a substantial share of the market and (2) whether the defendant competes with other manufacturers of the same product.

Judge Richard Posner of the Seventh Circuit concluded in *Valley Liquors, Inc. v. Renfield Importers, Ltd.*<sup>108</sup> that a plaintiff must initially demonstrate that the defendant had significant market power as evidenced by a significant share of the market.<sup>109</sup> In upholding the district court's denial of the plaintiff's motion for a preliminary injunction, the court relied on the plaintiff's failure to show that the defendant had significant market power.<sup>110</sup> Without such market power it was presumed that the defendant had no ability to raise prices significantly above the competitive level without losing business to competing sellers.<sup>111</sup> Only after significant market share is proven should a court address whether the restraint has sufficient redeeming virtues to satisfy the rule of reason.<sup>112</sup> That is, without market power the nonprice restraint can have no adverse effect on

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104. 579 F.2d at 128.

105. *Id.* at 133. See *Monsanto Co. v. Spray-Rite Serv. Corp.*, 104 S. Ct. 1464 (1984).

106. 579 F.2d at 133.

107. *Id.*

108. 678 F.2d 742 (7th Cir. 1982). See also *Graphic Prods. Distribs. v. Itek Corp.*, 717 F.2d 1560 (11th Cir. 1983) (plaintiff must establish defendant's market power); *Davis-Watkins Co. v. Service Merchandise Co.*, 686 F.2d 1190 (6th Cir. 1982) (upheld a jury instruction requiring the consideration of market power when applying a rule of reason test), *cert. denied*, 104 S. Ct. 1718 (1983).

109. 678 F.2d at 745.

110. *Id.*

111. *Id.*

112. See, e.g., *Davis-Watkins*, 686 F.2d at 1202.

interbrand competition. Therefore, it is presumed to be lawful. The Fifth and the Ninth Circuits also follow this approach.<sup>113</sup>

What constitutes a significant market share and, therefore, sufficient market power to affect interbrand competition adversely has not been answered authoritatively. Three recent decisions from the Ninth Circuit are illustrative. First, in *JBL Enterprises, Inc. v. Jhirmack*,<sup>114</sup> the court held that a market share of between two and four percent was "too small for any restraint on intrabrand competition to have a substantially adverse effect on interbrand competition."<sup>115</sup> This seems to suggest that a substantial share of the market, perhaps one-third to one-half, might satisfy a plaintiff's burden. However, in *Cowley v. Braden Industries, Inc.*,<sup>116</sup> the court ruled that the plaintiff must supply independent evidence of diminishing interbrand competition even though the seller had between seventy and eighty percent of the market in windmills.<sup>117</sup> This need for additional evidence also was apparent in the circuit court's approval of summary judgment for Sylvania after the case was remanded to it.<sup>118</sup> In *Sylvania*, the court pointed to the existence of other "viable television manufacturers available to sell to any retailers who wished to enter the Sacramento market, and [evidence that] their products were interchangeable with Sylvania's."<sup>119</sup>

Some courts have suggested in dicta that a vertical restraint might fail without supporting evidence of interbrand competition in the market. One possible consequence of the desire for such evidence is that the burden of presenting it may be placed upon the defendant. In *Muenster Butane, Inc. v. Stewart Co.*,<sup>120</sup> the Fifth Circuit seemed to limit its requirement that the plaintiff show an adverse effect on interbrand competition to those situations where

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113. See, e.g., *Muenster Butane, Inc. v. Stewart Co.*, 651 F.2d 292, 298 (5th Cir. 1981); *Cowley v. Braden Indus., Inc.*, 613 F.2d 751, 755 (9th Cir.), cert. denied, 446 U.S. 965 (1980).

114. 1982-83 Trade Cas. (CCH) ¶ 65,199 at 71,828 (9th Cir. 1983).

115. *Id.* See also *Hood v. Tenneco Texas Life Ins. Co.*, 739 F.2d 1012 (5th Cir. 1984) (less than 5% of the market share insufficient to establish market power); *Ron Tonkin Gran Turismo, Inc. v. Fiat Distribs., Inc.*, 637 F.2d 1376, 1379 (9th Cir. 1981) (defendant's share of foreign car market was between 2.48 and 5.2%); *Mutual Fund Investors v. Putnam Management Co.*, 553 F.2d 620, 627 (9th Cir. 1977) (defendant's sales of mutual funds comprised only 2 to 3% of total sales in the relevant market). But see *Graphic Prods. Distribs. v. Itek Corp.*, 717 F.2d 1560, 1570 (11th Cir. 1983) (70 to 75% market share sufficient to establish significant market power).

116. 613 F.2d 751 (9th Cir.), cert. denied, 446 U.S. 965 (1980).

117. *Id.* at 756.

118. 1982-83 Trade Cas. (CCH) ¶ 64,962, at 72,967 (9th Cir. 1982).

119. *Id.*

120. 651 F.2d 292 (5th Cir. 1981); see also *H & B Equip. Co. v. International Harvester Co.*, 577 F.2d 239 (5th Cir. 1978) (healthy interbrand competition established by evidence).

"[s]tiff interbrand competition in the relevant market shielded the consumer from an anticompetitive effect of [the manufacturer's] attempts to reduce the rivalry between dealers."<sup>121</sup> The concern in *Muenster Butane* and allied decisions seems to be that the costs to consumers of diminishing intrabrand competition might outweigh any benefits from interbrand competition if there is no interbrand competition in the market. One panel of the Second Circuit Court of Appeals explicitly adopted this balancing approach in ruling for a terminated dealer in *Eiberger v. Sony Corp. of America*.<sup>122</sup> This judicial cost-benefit approach to vertical restraints seems contrary to the Supreme Court's statement in *Sylvania* that interbrand competition is the primary concern of antitrust law.<sup>123</sup> And as the only appellate case where the plaintiff-dealer has prevailed, *Eiberger* may be an aberration.<sup>124</sup>

Although the absence of interbrand impact probably should be the controlling factor in upholding a vertical restraint, a majority of tribunals also look to other market conditions. Perhaps the leading advocate of this view is former FTC Commissioner David Clanton who, in *Beltone Electronic Corp.*,<sup>125</sup> relied on a number of market conditions to justify the territorial restrictions. Beltone's mere sixteen percent market share<sup>126</sup> alone did not enable it to require its dealers to work only within assigned geographical areas and to deal exclusively in Beltone hearing aids.<sup>127</sup> Looking beyond Beltone's market share, Commissioner Clanton relied on the rise of new distributional methods, the entry and growth of new competitors, and the resulting change in the market position of the leading firms.<sup>128</sup> This analysis is similar to the approach adopted by the Third Circuit in *American Motor Inns, Inc. v. Holiday Inns, Inc.*<sup>129</sup>

In *American Motor Inns*, the plaintiff (AMI), the largest franchisee of Holiday Inns (HI), sued HI following HI's denial of

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121. 651 F.2d at 298.

122. 622 F.2d 1068 (2d Cir. 1980). But see *Abadir & Co. v. First Miss. Corp.*, 651 F.2d 422 (5th Cir. 1981); *Borger v. Yamaha Int'l Corp.*, 625 F.2d 390 (2d Cir. 1980).

123. 433 U.S. 36, 52 n.19 (1977).

124. See text accompanying *infra* notes 151-55.

125. 3 TRADE REG. REP. (CCH) ¶ 21,934 (1982).

126. *Id.* ¶ 22,395.

127. *Id.* ¶ 22,375.

128. *Id.* ¶ 22,395.

129. 521 F.2d 1230 (3d Cir. 1975). See also *Tripoli Co. v. Wella Corp.*, 425 F.2d 932 (3d Cir.) (motive stemming from protection of public from harm is sufficient lawful purpose to support resale restrictions of potentially dangerous products), *cert. denied*, 400 U.S. 831 (1970).

AMI's application to open a new franchise.<sup>130</sup> Under its standard licensing agreement, HI also refused to allow AMI to build any other type of hotel in the disputed areas.<sup>131</sup> The Third Circuit vacated that part of the district court's judgment which held that the "non-Holiday Inn" clause failed a rule of reason analysis.<sup>132</sup> The court noted that the district court failed to consider not only the relevant market share but also such other factors as "the total competition extant in the industry," "the effect of the challenged restriction on the market structure," and "the number and size of firms in the industry."<sup>133</sup>

In sum, the case law reflects uncertainty about the impact of vertical restraints on interbrand competition. The primary dispute is whether a modest market share alone insulates a nonprice vertical restraint from attack or whether "other factors" must be weighed in determining its legality. Secondary, but still unanswered, issues include: what constitutes a substantial market share, whether a significant market share alone triggers a finding of actual or likely adverse effect or merely requires the defendant to come forward with anecdotal or economic evidence of no adverse market effect, and what other evidence is necessary to justify a restraint despite insubstantial market shares.

### B. *The Redeeming Virtues of the Restraint*

While most judicial attention has focused on the manufacturer's market power, the courts and the FTC also have reviewed the justifications for the restraint, at least where market power was more than de minimis or was not insignificant.

In a typical rule of reason case, the business rationale for the restraint is the focal point of the defendant's case. For example, in *Red Diamond Supply, Inc. v. Liquid Carbonic Corp.*,<sup>134</sup> the plaintiff alleged that Liquid Carbonic Corp. and three of its distributors conspired to maintain territorial and customer restrictions on the sale of Liquid's products.<sup>135</sup> Red Diamond claimed that its distributorship was terminated because it transgressed these restrictions.<sup>136</sup> The Fifth Circuit considered not only the "pernicious effect" on in-

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130. 521 F.2d at 1235.

131. *Id.* at 1248.

132. *Id.* at 1247.

133. *Id.*

134. 637 F.2d 1001 (5th Cir. 1981).

135. *Id.* at 1002.

136. *Id.*

terbrand competition, which it found to be nonexistent, but also the "redeeming virtues" of the restraints.<sup>137</sup> In particular, the court found that the restrictions enabled the manufacturer to serve its customers more effectively, thereby actually intensifying interbrand competition.<sup>138</sup>

In *Mendelovitz v. Adolph Coors Co.*,<sup>139</sup> the plaintiff beer wholesaler brought suit against a manufacturer for refusal to deal. The plaintiff had refused to honor territorial limitations and, as a result, was terminated by the manufacturer. The court found that the restriction was "essential to the efficient functioning of [Coors'] quality control procedure,"<sup>140</sup> which was designed to avoid the adverse effects of age, light, and heat on the quality of the beer. Other cases have noted the manufacturer's desire to have dealers maintain adequate storage and inventories as legitimate business reasons for a restraint.<sup>141</sup>

In another dealer termination case, *Donald B. Rice Tire Co. v. Michelin Tire Corp.*,<sup>142</sup> the court analyzed a territorial limitation placed by a tire manufacturer on its dealers. The court discussed the numerous marketing efficiencies which might be achieved through the imposition of vertical restraints.<sup>143</sup> With regard to the defendant's particular justifications for the territorial restrictions, the court felt that the manufacturer's concern that unauthorized dealers would neither advertise nor be able to perform necessary repair services justified the territorial restraint.<sup>144</sup> The court found evidence that the plaintiff, in fact, was free-riding on the promotional efforts and services provided by authorized dealers<sup>145</sup> and, therefore, concluded that the manufacturer's decision to terminate the plaintiff's dealership for refusal to comply with the restriction was not unreasonable.<sup>146</sup>

This notion of free-riders is prominent in the economic literature justifying manufacturer imposition of vertical restraints and was a persuasive influence on the Supreme Court's decision in *Syl-*

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137. *Id.* at 1005-06.

138. *Id.* at 1006.

139. 693 F.2d 570 (5th Cir. 1982).

140. *Id.* at 576.

141. See *Abadir & Co. v. First Miss. Corp.*, 651 F.2d 422 (5th Cir. 1981); *Cowley v. Braden Indus., Inc.*, 613 F.2d 751 (9th Cir.), *cert. denied*, 446 U.S. 965 (1980).

142. 483 F. Supp. 750 (D. Md. 1980), *aff'd per curiam*, 638 F.2d 15 (4th Cir.), *cert. denied*, 454 U.S. 864 (1981).

143. *Id.* at 756.

144. *Id.* at 757, 758-59.

145. *Id.* at 757-58.

146. *Id.* at 762.

vania.<sup>147</sup> The FTC's opinion in *Beltone*<sup>148</sup> also examined the economic implications of free-riders. Without its territorial restrictions, Beltone's "advance-contact system," whereby dealers identified and tested potential hearing aid users, could easily be undercut by dealers from outside the territory.<sup>149</sup> Effective advertising programs also might have been hindered, according to the Commission.<sup>150</sup> It is not clear from the opinion whether these justifications were necessary to the respondent's exoneration or merely an additional, alternative holding.

Only one appellate post-*Sylvania* decision has found a vertical price restraint unjustified.<sup>151</sup> In the somewhat bizarre *Eiberger* case, one dealer sought to "enforce" a manufacturer's territorial program by going on a rampage and ripping open boxes in another dealer's store looking for evidence of extraterritorial sales.<sup>152</sup> In *Eiberger*, the warranty service assessment imposed by Sony on all authorized dealers might have been difficult to explain because it applied whether or not warranty services were in fact performed.<sup>153</sup> In any case, a panel of the Second Circuit concluded that the manufacturer's objectives could have been achieved by a less restrictive requirement such as paying the dealer for actual warranty services.<sup>154</sup> The importance of this decision seems to have been undercut by another panel which did not adhere to the less restrictive alternative approach in upholding a territorial clause.<sup>155</sup>

As this review suggests, the number of cases evaluating the "redeeming virtues" of a restraint is still relatively few. Like Justice Powell, they do little more than list the justifications or announce why a particular restraint could be reasonable. Neither the analysis nor empirical data seem particularly impressive.

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147. 433 U.S. at 55.

148. 3 TRADE REG. REP. (CCH) ¶ 21,934 (1982).

149. *Id.* ¶ 22,385. That is, competing discounters could rely on Beltone's activities informing consumers of their hearing loss to sell these customers hearing aids. Without incurring these advance-contact costs, the free-riding competitors would have a substantial cost advantage.

150. *Id.* ¶ 22,383.

151. *Eiberger v. Sony Corp. of Am.*, 622 F.2d 1068 (2d Cir. 1980).

152. *Id.* at 1073-74.

153. *Id.* at 1077-78.

154. *Id.*

155. *Borger v. Yamaha Int'l Corp.*, 625 F.2d 390 (2d Cir. 1980).



#### IV. RATIONALIZING THE "RULE OF REASON"

##### A. *Vertical Restraint Cases*

The rule of reason standard is increasingly important as courts apply it not only to vertical restraints but also to arrangements which traditionally have been per se illegal. Therefore, it is important that the standard be developed in a manner which provides guidance to both the courts and the business community. Unfortunately, the standard has not been adequately developed in the vertical restraint cases. Most vertical restraint cases at the appellate level present contract rather than antitrust questions. Whether a manufacturer's termination of a dealer because of inadequate dealer performance or a change in distribution patterns was authorized or contemplated by the parties at the time of contract formation is a question for contract law.<sup>156</sup> However, habits developed under the *Schwinn* rule, and antitrust remedies providing for treble damages and attorneys' fees, encourage disappointed dealers to pursue antitrust remedies as well. The result after *Sylvania* is that these plaintiffs usually lose.

It is clear from these cases that counsel for plaintiffs have not fully understood the meaning of *Sylvania*, at least as interpreted by most commentators and lower courts. This confusion is not surprising given the ambiguous and incomplete development of the economic factors to be considered under the rule of reason standard as set forth in *Sylvania*. The difficulty is that the Court has only partially accepted the economic theory of then-Professors Bork<sup>157</sup> and Posner.<sup>158</sup> This theory illustrates that vertical restrictions are generally harmless because they do not create market power or restrict output and are likely to be adopted to achieve the manufacturer's and dealer's marketing goals.

The Court's failure to embrace fully the legality of vertical restraints probably lies in the difficulty of forging a six-person majority to overturn *Schwinn*. To do so, Justice Powell apparently had to distinguish *Dr. Miles* and leave the per se rule undisturbed.<sup>159</sup> As a

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156. See, e.g., Gellhorn, *Limitations on Contract Termination Rights—Franchise Cancellations*, 1967 DUKE L.J. 465; Goldberg, *The Law and Economics of Vertical Restrictions: A Relational Perspective*, 58 TEX. L. REV. 91 (1981).

157. See Bork, *supra* note 5.

158. See Posner, *supra* note 77.

159. Cf. Justice William Rehnquist's speech of Sept. 15, 1984, quoting former Chief Justice Hughes, *quoted in* N.Y. Times, Sept. 16, 1984, § 1, at 27.

If our opinions seem on occasion to be internally inconsistent, to contain a logical fallacy, or to insufficiently distinguish a prior case, I commend you to the view attributed to Chief Justice Hughes upon his retirement from our Court in 1941. He

result, the Court did not focus exclusively on the economic effects (i.e., output restrictions) of the arrangement on interbrand competition alone—although it acknowledged that interbrand effects were the primary concern.<sup>160</sup> Instead, it confused the issue by discussing the intrabrand impact of the restraint and by condemning all direct price-fixing. As Professor Wesley J. Liebler points out, all vertical restraints, price or nonprice, have similar price effects and cannot be distinguished on economic or other analytical grounds.<sup>161</sup>

Where does this leave the practicing attorney forced to represent his client and the law before a court? Where does it leave a lower court? One route, of course, is to invite the Supreme Court to re-think elements of its *Sylvania* decision and to correct current analytical and doctrinal limitations. This is not an appealing suggestion for most practitioners whose clients are not anxious for their disputes to become test cases. Nor does it really help the conscientious judge bound by precedent.

On the other hand, the inherent inconsistencies in *Sylvania* and the divergent case authority provide creative counsel and judges with an opportunity to rationalize not only the law of vertical restraints but also the law governing arrangements which traditionally have been per se illegal and now are being subjected to a rule of reason analysis. If the bench and bar are to seize this opportunity, they must understand why certain restraints are being tested by a rule of reason. The theory underlying the Court's analysis of vertical restraints in *Sylvania* is simply that vertical restraints generally are adopted to achieve marketing goals such as dealer servicing and advertising. Vertical constraints are designed by manufacturers to gain an edge on their competitors. They are unlikely to have an interbrand effect unless they are part of a dealer or manufacturer cartel. Both economic and legal analysis, as numerous commentators have explained, demonstrate that the use of vertical restraints to achieve either kind of cartel is highly unlikely.<sup>162</sup>

Proof under the rule of reason standard should concentrate on evidence indicating that the vertical restraint is an integral part of an agreement among manufacturers or dealers to fix prices among

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said that he always tried to write his opinions logically and clearly, but if a Justice whose vote was necessary to make a majority insisted that particular language be put in, in it went, and let the law reviews figure out what it meant.

*Id.*

160. 433 U.S. at 52 n.19.

161. Liebler, 1983 *Economic Review of Antitrust Developments: The Distinction Between Price and Nonprice Distribution Restrictions*, 31 UCLA L. REV. 384 (1983).

162. See Posner, *supra* note 5; Posner, *supra* note 77.

competing firms at one level or another. Evidence of an agreement between a manufacturer and dealer, despite the *Monsanto* decision, will not support such a finding since it generally is not in the interest of one to foster a cartel by the other.

Although the Court's decision in *Monsanto* failed to set forth an adequate standard for proving the existence of a "conspiracy," it is clear that "something more" is required than mere evidence that a dealer's termination was preceded by price complaints. It also should not be enough to show that the terminated dealer charged lower prices or was a maverick since nonprice vertical restraints are likely to be designed to assure uniformity in distribution and to achieve improved product and service quality. Evidence that vertical restrictions support a horizontal cartel should be viewed skeptically since the cartelization of a market is exceedingly difficult without some sort of government assistance through, for example, blocking patents or sealed bid procedures. Finally, the current focus on market share seems analytically unsound even though it is not likely to result in error. Its effect is to focus time and attention on less significant evidence of market power rather than on direct evidence of reduced output or higher prices.

### B. *Per Se Violations*

It is clear from the opinions in *Broadcast Music*, *Hyde*, *Monsanto*, and *NCAA* that there also are valid economic justifications for arrangements which traditionally have been considered per se illegal. The Court is critically analyzing these arrangements in modern economic terms. Before subjecting a defendant to the per se rule, the Court has analyzed some horizontal restraints in a manner similar to the rule of reason approach followed in vertical restraint cases. In *Broadcast Music*,<sup>163</sup> the Court examined a horizontal agreement to fix prices, typically a per se violation of section 1 of the Sherman Act, in terms of its competitive effects and redeeming virtues. The Court applied a similar rule of reason analysis in *Hyde*<sup>164</sup> to uphold a tying arrangement, although it left the general per se approach to tying theoretically intact. In *Hyde* the Court also considered the market power of the parties to the agreement and the effect of the restraint on competition in the market. In *NCAA*,<sup>165</sup> the Court conducted a rule of reason analysis before

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163. 441 U.S. 1 (1979).

164. 104 S. Ct. 1551 (1984).

165. 104 S. Ct. 2948 (1984).

rejecting the college athletic association's justifications for an agreement limiting the number of college football games on television.

It is especially important to develop the meaning of the rule of reason analysis in light of the Court's movement away from a rigid application of the *per se* rule. This analysis typically entails a discussion of the "pernicious effects" on competition and the "redeeming virtues" of the restraint. Anticompetitive effects most often are analyzed in terms of the defendant's market share and, in some courts, other evidence of market conditions. The concentration on market share is misplaced.<sup>166</sup> The focus of the analysis should be on the likely effects of the restraint. If industry output is not affected, it is irrelevant what effect the arrangement has on a particular manufacturer's output. Of course, manufacturers are likely to seek increased output and improved market positions. Claims to the contrary should bear a heavy burden. Otherwise, application of the antitrust laws will reduce rivalry and, as a consequence, harm consumer welfare.

## V. CONCLUSION

The Supreme Court's most recent antitrust decisions illustrate a breakdown of the previous guidelines on when to apply the *per se* rule or the rule of reason standard. Whether a restraint will be subjected to a *per se* rule or whether it passes a rule of reason test is to be determined by very similar economic considerations. The standard under the rule of reason, as set forth by Justice Powell in *Sylvania* and in subsequent Supreme Court cases, provides little guidance on the meaning of the rule. The Court is gradually embracing a "consumer welfare" approach to antitrust analysis and deviations in this movement, such as the approach in *Maricopa*,<sup>167</sup> seem unlikely to flourish. The current situation presents an oppor-

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166. Since vertical restrictions generally cannot alter market power significantly, it is also inappropriate to rely on market concentration analysis in applying the rule of reason standard to vertical restraints. As a filter for prosecutorial discretion, as applied by the Department of Justice's Vertical Restraints Guidelines and, separately, by Professor Easterbrook, they may be an inexpensive device for approving obviously harmless restrictions. See *Vertical Restraint Guidelines*, [Spec. Supp.] ANTITRUST & TRADE REG. REP. (BNA) No. 1199 (Jan. 24, 1985); Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984). The danger is that this test will be applied affirmatively to challenge vertical restraints even though competition is intense and the restraints enhance consumer welfare. The history of the use of concentration measures to find horizontal mergers presumptively illegal justifies this concern, particularly in the absence of theoretical and empirical support. Cf. Gellhorn, *Government Merger Policy and Practice — 1983*, 52 ANTITRUST L.J. 419 (1983).

167. *Arizona v. Maricopa Co. Medical Soc'y*, 457 U.S. 332 (1982).

tunity to rationalize the rule of reason and shape the future of anti-trust analysis in terms of modern economic considerations.